No. 9393

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CO-OPERATIVE OIL ASSOCIATION, INC.,
an Association,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF OF PETITIONER

Upon Appeal from the United States Board of Tax Appeals.

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Residence: Caldwell, Idaho,

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STATEMENT AS TO JURISDICTION

MAY IT PLEASE THE COURT:

Petitioner, in support of the jurisdiction of this Court to review the above entitled cause, respectfully represents:

Board of Tax Appeals Had Jurisdiction:

Title 26, Chapter 5, United States Code Annotated.

Jurisdiction of This Court:

This Court has jurisdiction on appeal under Subchapter B, Sections 640-1-2, Chapter 5, Title 26, United States Code Annotated.

The decision of the Board was entered July 10, 1939 (R. p. 31), and Petitioner's petition for review was filed October 5, 1939 (R. p. 37). The Board ordered and decided that there are deficiencies in Petitioner's income tax for the year from January 1, 1934, to October 31, 1934, and for the fiscal

year ending October 31, 1935, in the amounts of $1,065.25 and $1,696.33, respectively; and deficiencies in excess profits tax for the same years in the amounts of $387.36 and $618.39, respectively (R. p. 31).

STATEMENT

The sole question here involved is whether certain savings made by Petitioner's member-producers of agricultural products, in securing their supplies through Petitioner co-operative association during the taxable periods involved, were an obligation and liability of Petitioner to its member-producers and, hence, although not distributed during such taxable periods, were deductible and not taxable as income or excess profits under the United States Revenue Laws.

Petitioner is a non-profit co-operative marketing association organized and existing under and by virtue of the Co-operative Marketing Act of the State of Idaho, with its principal office and place of business at Caldwell, in the County of Canyon, State of Idaho.

In the taxable year, January 1, 1934 to October 31, 1934, Petitioner deducted the sum of $6,872.68 as savings belonging to member-producers and, although not distributed, as a liability from Petitioner to such members. Such deduction was disallowed by the Commissioner and deficiency income tax liability imposed in the sum of $1,065.25, and deficiency excess profits tax liability in the sum of $387.36, making a total of $1,452.61.

In the taxable year, October 31, 1934, to October 31,

1935, Petitioner deducted the sum of $11,147.30, as savings belonging to member-producers and, although not distributed, as a liability from Petitioner to such members. Such deduction was disallowed by the Commissioner and deficiency income tax liability imposed in the sum of $1,696.33, and deficiency excess profits tax liability in the sum of $618.39, making a total of $2,314.72.

Under the Co-operative Marketing Act, above mentioned, Petitioner was not organized to make a profit for itself, as such, but only for its members as producers. (Sec. 22-2002, Idaho Code Annotated.) A record was kept of the savings involved herein, the mechanics of keeping such record being a single account, which, together with certain work sheets and folders containing sales accounts of individual member-producers, showed the exact amount which Petitioner owed to each member-producer on account of such savings (R. p. 54). Although this account was called a "reserve" it was merely an account showing the liability of Petitioner to its member-producers for savings which belonged to them (R. p. 73). In selling memberships it was represented and understood that such savings would belong to members (R. p. 76). In sending reports to members, the funds in this account were shown as savings to members (R. p. 70). When any member inquired as to the amount that Petitioner owed him, this account, together with the work sheets and the member's folder, with his sales tickets, was used in computing the amount owed by Petitioner to such member and such member was advised that Petitioner was indebted to him in such amount (R. p. 74). The articles of incorpora-

tion, by-laws, and marketing agreement of Petitioner, specifically made such savings the property of member-producers, and the amount of such savings held by Petitioner an obligation and liability by it to members. The purpose of the officers and agents of Petitioner in setting up this account, as well as the representations and agreement between Petitioner and members, clearly manifested the intention of the parties that the funds evidenced by this account, however designated, belonged to members and was an obligation and liability to members.

The Board of Tax Appeals held that Petitioner was not entitled to deduct such savings and that the same were taxable. It is a review of such decision that Petitioner seeks herein.

SPECIFICATION OF ERRORS

The assignments of error set out in some detail a number of errors (R. p. 34-36). In brief they are:

1. The failure of the Board to allow as a deduction for the taxable year from January 1, 1934, to October 31, 1934, members' savings in the sum of $6,872.68, and for the taxable year October 31, 1934, to October 31, 1935, members' savings in the sum of $11,147.30.

2. The failure of the Board to hold and recognize the liability of Petitioner to its members for the savings above mentioned; and in the Board ignoring and closing its eyes to the manifest intent of the Co-operative Marketing Act of the State of Idaho, Petitioner's articles, by-laws, and marketing agreement, and the intent and understanding of Pe-

titioner and its members that the savings deducted as hereinbefore mentioned, belonged to Petitioner's member-producers, and that an obligation and liability therefor existed to them from Petitioner.

3. The holding of the Board that the savings above mentioned had been excluded by Petitioner through an act of its board of directors, and thus were not an obligation or liability of Petitioner to its member-producers, basing such holding upon a technical construction or fiction, manifestly contrary to the good faith, intention and understanding of Petitioner and its members, the record clearly showing no act on the part of Petitioner's board of directors excluding such savings, and the Act under which Petitioner was organized, its articles, by-laws and marketing agreement and the understanding between Petitioner and its member-producers being clear that the savings involved belonged to such members, and, even if undistributed, at all times were an obligation and liability on the part of Petitioner to its members.

4. In finding and holding that there are deficiencies in income taxes for the year from January 1, 1934, to October 31, 1934, and for the fiscal year ending October 31, 1935, in the amounts of $1,065.25 and $1,696.33, respectively, and in finding and holding that there are deficiencies in excess profits taxes for the same years in the amounts of $387.36 and $618.39, respectively.

SUMMARY OF THE ARGUMENT

1. Co-operatives organized under the Co-operative Marketing Act of the State of Idaho are deemed non-profit and

are not organized to make profits for themselves, as such, or for their members, as such, but only for their members as producers.

Section 22-2002, Idaho Code Annotated.

2. Where, under a co-operative's articles of incorporation, by-laws, or marketing agreement, savings belong to member-producers and a liability is thus created to such member-producers, the entry of such savings upon the co-operative's books, regardless of its designation, is no more than a record of such liability and neither the basis of accounting, whether on accrual or cash basis, nor the fact that no cash was paid to such producers in the taxable years involved, is material, and such savings are properly deductible.

Anamosa Farmers Creamery Co. v. Commr. of Internal Revenue, 13 B.T.A. 907.

Farmers' Union Co-Operative Association v. Commr. of Internal Revenue, 13 B.T.A. 969.

3. The good faith, intention and understanding of a co-operative and its member-producers should be accepted as to transactions as they were actually, in fact, and a technical construction or fiction should not be invoked to thwart such intention, good faith and understanding.

Bettendorf v. Commr. of Internal Revenue, 49 Fed. (2) 173, 176.

112 W. 59th St. Corporation v. Helvering, Commr., 68 Fed. (2) 397.

Randolph v. Commr. of Internal Revenue, 76 Fed. (2) 472.

4. Where a co-operative is organized under a marketing act expressly providing that no income or profits should accrue to anyone but member-producers, as such, and the articles of incorporation of such co-operative expressly provide that all savings should be paid to such producers and there is no act on the part of the board of directors of such co-operative excluding any portion of such earnings or placing them in any reserve such as contemplated by such articles, such savings, even though undistributed, remain the property of such producers and, while retained by the co-operative, are owing to such producers and are properly deductible as such liability from the tax returns of such co-operative.

AGRUMENT

The Board of Tax Appeals conceded that the savings involved were properly deductible and not taxable, even if undistributed, if a liability or obligation on the part of Petitioner to its members actually existed for the same; that such obligation or liability existed is clear, particularly from the provisions of Petitioner's articles, that the "net income * * * shall be distributed to the stockholding patrons * * * " (R. p. 24). The Board, however, premised its decision upon the fact that Petitioner's board of directors had excluded the savings involved as a "reserve," and had therefore removed the same as a liability to its members (R. p. 29).

Such premise is without foundation. Petitioner's board of directors never set aside such savings as a reserve or otherwise. No such action was ever taken by Petitioner's

board of directors and no reference to any such action can be found in the record.

The Board, in its decision, refers to Petitioner's position "that a liability to pay the entire yearly savings was created by the articles of incorporation, the by-laws, the membership agreement and that it was also recognized by the communications sent by the petitioner to its members" (R. p. 29). The Board proceeds to point out that the income shall be distributed, except the portion "which may be set aside as reserve funds by the board of directors." It then bases its decision upon the following statement:

> "In keeping with this provision the Board of Directors excluded a certain portion of the Petitioner's earnings and placed it in the account entitled: 'Reserve for Working Capital.'" (R. p. 29).

In other words, the Board's decision is based upon the proposition that although there was an obligation and liability on the part of the Petitioner to its members for the savings involved, the board of directors excluded these particular savings by setting them aside in a "reserve" such as contemplated by the provisions above mentioned. In addition to the fact that there is no finding to support such a decision, and no evidence of any such action on the part of Petitioner's board of directors, the record clearly shows that the agreement, the intention and the acts of the parties involved were manifestly that such savings were the property of the members, and there existed an obligation and liability for the same from Petitioner to its members.

The Board specifically based its decision on a "reserve

fund" within the meaning of the provisions of Article X of Petitioner's articles of incorporation, which fund might be "set aside as reserve funds by the Board of Directors." Not only is there no evidence that such a fund was ever set aside by action of the board of directors, but the evidence is clearly to the contrary. Mr. Barrett testified that there was a "reserve for contingencies, obsolescence and extensions." He then said:

> "This is the only reserve set up by the Board of Directors by action of resolution. It is the only one that appears in the Minutes." (R. p. 72).

Accordingly, there is no basis for the Board's decision, and the mere fact that the savings involved were not paid out or distributed during the taxable years above mentioned, or were used by Petitioner during the time that these funds were received and the time that they were actually paid to the producers, could not and did not alter their status or the obligation and liability for the same on the part of Petitioner to its member-producers.

Petitioner's General Manager testified that the monthly report showed the savings of the members, and that:

> "These accumulate through the year, month by month, and at the end of the year these savings are set up as a liability to the members by Petitioner. The savings, then, are shown each month in this statement, and, taken in connection with the folders showing the patronage of individual members, the savings of the members are carried as 'Group One Account.' These savings of Petitioner's members are kept in one account in connection with the folders of individual members." (R. p. 54).

Nowhere in the record was this statement, that these savings were set up as a liability by Petitioner to its members, contradicted.

In statements sent out to members, the funds in this so-called "reserve" are shown as savings (R. p. 70). In referring to this so-called "reserve," upon which the Board's decision is based, Petitioner's Manager testified:

> "I identify (it) as the one heretofore referred to by me as showing the savings belonging to the members."

Can there be any question that, regardless of denomination by Petitioner's bookkeepers, it was the intent of all parties that this account was simply the aggregate accrual of savings of members which, together with the folders above mentioned, showed the exact amount of net savings due each individual member? On the same page of the transcript Mr. Barrett further testified, referring to the same account:

> "During the period from December 1, 1933, to October 1, 1934, the same account was kept as a reserve, showing savings of Petitioner's members." (R. p. 71).

It was not denied that the terminology used was rather loose (R. p. 72), yet the Board fastens to this account the technical meaning necessary to bring it within the provisions of the articles above mentioned, although contrary to the intent and understanding of the parties involved.

In further explaining the account involved, Mr. Barrett testified that no resolutions were ever adopted by the board of directors with reference to this account (R. p. 72). He then said:

> "Folders were kept containing sales tickets for each member, but no accounts were set up in the general ledger showing any amounts contained in the account, 'Reserve for working capital,' as to each member. No accounts were set up on the general ledger for members of Petitioner showing any allocation of the amount in the account, 'Reserve for working capital,' but Petitioner did have the total, the purchases of each member and for each year, and from a balance sheet the equity of each member was determined. In addition to a folder for each member, Petitioner also had work sheets which went into the general ledger or books of Petitioner." (R. pp. 72-73)

The Board entirely ignored the uncontradicted testimony and record with reference to the actual purpose and intent of the so-called "reserve." The General Manager said:

> "It was not a reserve at all. It was merely liability account, carried as a liability on our balance sheet—as a liability to our members. This item, 'Reserve for working capital,' evidences the savings due Petitioner's members. These savings were kept all in one account, the name being sometimes changed." (R. p. 73)

Now, further showing the intent and understanding as between Petitioner and its members as to their agreement with reference to the funds involved, there is no contradiction of this testimony:

> "Now, referring again to the reserve and work sheets that we had, and heretofore mentioned, various members would at various times call upon us and ask how much of this account or savings in this reserve belonged to them or was due them. We would take in the work sheet and see their other purchases and from our ledger we would note the percentage. For instance, if a member traded $100.00 worth and had a saving of ten per cent, he would have $10.00 coming. That is the

> amount we would tell the member Petitioner owed him out of the so-called reserve. This was true during both years involved in this matter." (R. p. 74)

The Board absolutely ignored all testimony as to what this account was in fact, and that manifestly it was not such an account as contemplated by the word "reserve" in Petitioner's articles, but, the Board merely by reason of its designation as a reserve, changed the entire account, regardless of the understanding or agreement of the parties. The Chairman of Petitioner's Board of Directors testified as to the agreement and understanding between Petitioner and its members. He said that he would go out among the members and solicit memberships, particularly during the period involved in this matter. He testified:

> "I stated to them the mechanics of the operation of Petitioner, stating generally that our organization was based upon the principle of memberships taken out or sold with the idea that when members bought merchandise the savings they effected from patronizing their own organization would be released to them from time to time as occasion arose. We were very definite in explaining to the members that the savings could not belong to anyone except the members, and would be paid to the members from time to time. (R. p. 76)

In the case of Home Builders Shipping Association vs. Commissioner, 8 U. S. Board of Tax Appeals Reports 903, the articles provided that the profits should be divided annually among the stockholders. It was then pointed out: (p. 906)

> It was then orally agreed between the stockholder and the petitioner that the petitioner would later pay the stockholder an amount equal to the difference be-

> tween the price at which the petitioner resold the wheat, and the price originally paid the stockholder at the time of delivery plus the cost to the petitioner of reselling the wheat. Such so-called patronage dividends were actually paid to the stockholders on all 1916 and 1917 purchases but were not paid on the 1918 purchases for the reason that the petitioner did not have the money with which to make the payments."

It was then held: (p. 908)

> "We know of no reason why the amount of $4,137.70 should not be treated as a part of the cost of wheat purchased. It was intended by all of the parties that it should be so treated."

Can there be any question as to the intent and understanding of the parties involved as to the savings belonging to the members in this matter? Had the officers and bookkeepers of Petitioner co-operative been expert accountants and lawyers, there might even be some doubt as to the right of the Board to invoke a technical construction or fiction contrary to the obvious intent and understanding of Petitioner's officers and agents and of the agreement between Petitioner and its members; manifestly, however, in the case at bar, the Board was not justified in closing its eyes to the acts, agreements, and conduct of the parties, and refusing to give the meaning to the same, intended by the parties themselves.

> "The government will not resort to sharp practice, nor invoke technical construction or fiction, which will manifestly thwart the good-faith intention of its taxpayers, for the purpose of visiting a tax burden upon one who in fact did not, except by construction, derive any beneficial income from the transaction."

Bettendorf v. Commr. of Int. Rev., 49 Fed. (2d) 173 and 176.

Cited with approval in Randolph v. Commr. of Int. Rev., 76 Fed. (2d) 472.

"Tax laws are essentially practical in their purposes and application, and the federal income tax laws are no exception. * * * a cardinal purpose of the income tax laws is to tax the income to the person who has the right or beneficial interest therein, and not to throw the burden upon a mere collector or conduit through whom or which the income passes."

Central Life Society v. Commr., 51 Fed. (2d) 939, 941.

112 W. 59th Street Corporation v. Helvering, Commr., 68 Fed. (2d) 397.

After excluding the savings involved as being a "reserve," contemplated by Petitioner's articles, the Board proceeds to base its decision upon the holding in Farmer's Union Street Exchange v. Commr., 30 B.T.A. 1051. This holding, however, can be distinguished upon a number of grounds. Suffice it to say, however, the holding that the provision contained in the articles could not be "construed as creating in each year a definite liability to pay the entire saving of that year," is clearly justifiable inasmuch as Article VIII of the articles involved, specified that the by-laws (articles construed to have same force) should provide "for the distribution of the earnings of this corporation in part, or wholly on the basis of, or in proportion to the amount of property bought from or sold to members * * * or of labor performed, or other service rendered * * *" Surely it can-

not be contended that there is any similarity between these provisions and the definite provisions in the case at bar, providing that all of the savings be paid to members.

Moreover, the statutory provisions of Idaho definitely clarified the intent and purpose of the provision in Petitioner's articles, by-laws, and marketing agreement with reference to the payment of savings to members. Petitioner was organized under the Co-operative Marketing Act of the State of Idaho, Chapter 20, Title 22, Idaho Code Annotated. Prior to the enactment of this law, rather disastrous experience was had in connection with co-operatives in Southern Idaho. Speculative practices had generally defeated the purpose of cooperation. The purpose of the law was to prevent, if possible, repetition of such failures. It was for this reason that it was so clearly enunciated in the Act that the co-operative organized under it could not make a profit either for itself or for any of its members as such. The experience had been that the right of a co-operative to speculate and make profit either for itself or for its stockholders and members, as such, was conducive to unwholesome operations, with resulting loss to farmers and producers as such. The entire theory of the Act was, therefore, changed, and under the organic act, by virtue of which Petitioner obtained the right of existence, it cannot make any profit for itself or for any of its stockholders or members as such. The law specifically provides that any profit or saving must be for members, as producers, and not as members or stockholders of the co-operative.

Section 22-2002, Idaho Code Annotated, specifically states:

> "Associations organized hereunder should be deemed non-profit, inasmuch as they are not organized to make profits for themselves, as such, or for their members, as such, but only for their members as producers."

In line with this policy, so clearly enunciated and understood by every person interested in co-operatives in the State of Idaho, the articles and by-laws of Petitioner were drafted. No alternative was left to anyone as to the income; hence the articles provided that "the net income of the association * * * shall be distributed to the stockholding patrons of this association. * * *" Again, the by-laws provide that "the net income of this corporation * * * shall be distributed to the stockholding patrons of this association * * *."

The mere fact that such savings are not distributed and are set up in an account such as the one involved in this case, does not change the policy of the law nor the ownership of the funds which belong to the patrons, and not to the association or to its members or its stockholders as such, but only to members as producers of agricultural products. If all persons engaged in the co-operative movement were attorneys or auditors, perhaps more accurate phraseology would have been used. The mere fact that the savings in the so-called "reserve,"—sometimes called "group account," sometimes "working capital," or however they may have been designated—were not distributed or disbursed, would not change the obligation or liability of Petitioner to its mem-

bers. As heretofore pointed out, Petitioner's records were so kept that the interest of every participant in these savings could be ascertained at all times and when, later, the savings involved were distributed they were based upon such records and computed accordingly.

In the case of Anamosa Farmers Creamery Co. v. Commr. Int. Rev., 13 B.T.A. 907, the articles provided:

> "* * * all balance left after purchases, expenses and sinking funds have been provided for, shall be paid over to the patrons for butterfat."

The Board held that after paying operating expenses and dividends, the balance was credited to patrons, saying: (p. 908)

> "This procedure was in recognition of a liability created by the by-laws which are a contract between such a corporation and its patrons. In this situation neither the basis of accounting nor the fact that no cash was paid to the patrons in the taxable year is material."

In Farmers Union Co-operative Association v. Commr. Int. Rev., 13 B.T.A. 969, the articles again provided:

> "The remaining balance shall be divided pro rata among those customers who are Union Members on the basis of the value of business transacted with the corporation.

The Board held: (p. 970)

> "An entry on its books was no more than the record of a liability created by its by-laws and in this situation we are of the opinion that whether the books were kept on an accrual or cash basis is not material. The books did show the amounts distributable as patronage dividends and this was a liability at the close of the Petitioner's fiscal year."

In the case at bar it cannot be questioned but that the obligation and liability of Petitioner to its members for the savings involved is clearly fixed and established by the law under which Petitioner is organized, and by its articles, by-laws, and marketing agreement. The mechanics of bookkeeping, in having one ledger account which, together with work sheets and folders of each individual member, was sufficient to permit the determination of the exact amount of the liability of Petitioner to each and every patron, are not material, nor can the phraseology used with reference to the details of such account, or the reference to the savings as profits and transactions as sales and purchases, alter the nature of the co-operative involved, the relationship between it and its patrons as established by its articles, by-laws, and membership agreement, and the intent, understanding and agreement of Petitioner and its patrons. Petitioner, under the Co-operative Marketing Act of Idaho, can neither suffer loss nor enjoy profit. Petitioner becomes only an interested party, with an irrevocable power to manage and control all movements and acts necessary in its operation and in the marketing and supplying of products for distribution, and in prorating the costs, expenditures of the proceeds, and the distribution of the receipts to patrons. Not only can Petitioner neither suffer loss nor enjoy a profit as an association, but all receipts must be delivered back to members supplying the products, after deducting and prorating actual cost. No part of the receipts can be retained as association property or distributed to stockholders or members as such, but only to patrons.

The purpose of the Act, and the understanding of all concerned at all times, has been and now is that the association acts in the nature of an agency for its members, not in a proprietary capacity for itself.

The organic act under which Petitioner is organized, Petitioners articles, by-laws, and marketing agreement, cannot be construed otherwise than as creating a liability and obligation on the part of Petitioner to its patrons for the savings involved. When memberships are solicited, the representations are made, and it is clearly understood, that these savings become the property of patrons. The so-called "reserve" or account into which these savings are placed, was established and maintained during the years involved, with the intent and understanding on the part of the officers and agents of Petitioner that this account represented a liability of Petitioner to its patrons, and to each one of them in accordance with the amount as shown by this account, the work sheets and the individual folders, as hereinbefore mentioned. Petitioner's patrons also understood this to be a fact, not only from the representations made when memberships were obtained, but from the statements sent by Petitioner to such patrons. Under these circumstances the obligation and liability of Petitioner to patrons for the liability involved was clear and no distribution or other act by Petitioner was necessary.

CONCLUSION

WHEREFORE, We respectfully submit that the savings involved in this matter were properly deductible; that there

is no deficiency in either Petitioner's income or excess profits taxes; that the holding, finding and decision of the Board of Tax Appeals is erroneous and should be reversed, vacated, and set aside.

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